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SUBJECT: GDP GROWTH CONFRONTS GLOBAL 2007 SLOWDOWN

Ref: Paris 7477

11. SUMMARY: In its December overview of the French economy, the French National Statistical Agency forecast GDP growth to rebound to 3.6 percent (annualized) in the fourth quarter of 2006 after no growth in the third quarter. The forecast puts 2006 GDP growth at 2.1 percent, the bottom of the 2.0-2.5 percent range forecast by the government. GDP in each of the first two quarters of 2007 is forecast to stay at 2.0 percent (annualized) due to a moderate deterioration in the global economy. Slowing exports and a strong euro have led to calls from PM de Villepin and other French politicians for a clarification of the respective roles of the ECB and eurozone governments in setting exchange rate policy. Despite the slowing in GDP growth in the first half of 2007, the unemployment rate should decrease to 8.2 percent by June 2007 due to demographic factors. END SUMMARY.

GDP Growth Should Rebound in Q-4

12. INSEE raised its forecast of Q-4 GDP growth from 2.4 percent to 3.6 percent, taking into account an October survey of manufacturers that showed business confidence near a five-year high, and portended a 1.3 percent increase in the production of manufactured products in Q-4. Industrial production showed an unexpected 0.1 percent decrease in October compared with September due to a fall in the energy and capital goods sectors. Nonetheless, production in the manufacturing sector including construction increased 0.3 percent compared with September. The INSEE forecast is based on a 6.1 percent (annualized) rebound in exports in Q4 after a 2.8 percent decrease in Q-3. The French trade figures for October showed a larger-than-expected deficit of 2.7 billion euros due to an increase in imports and no increase in exports. The foreign trade balance in the first ten months deteriorated to 23.7 billion euros (31 billion USD).

13. Eric Dubois, INSEE chief economist, said that "a fourth quarter rebound would correct the third quarter stagnation" (ref). The Q-4 GDP growth is above the 2.4-3.2 percent growth expected by Finance Minister Thierry Breton. The INSEE forecast puts 2006 GDP growth at 2.1 percent, the bottom of the 2.0-2.5 percent range forecast by the government. If accurate, France would lag behind the 2006 euro zone growth rate of 2.6 percent projected by the European Central Bank.

2.0 Percent (annualized) GDP Growth Expected
for Q1 and Q2 2007

14. INSEE forecast 2007 GDP to increase 2.0 percent (annualized) in Q-1 and Q-2 "if the international economic slowdown is not too pronounced" said Dubois, who also indicated that "the first half of

2007 will fall back to a more moderate growth rate as foreign demand cools." Demand for French exports would decrease due to a slowdown in global economic growth, which is expected to be dragged down by the US, China and Japan. INSEE anticipates a tightening of monetary conditions in large economies including the U.S. and the euro zone. The first half of 2007 should be marked by an increase in the VAT in Germany, which would likely increase German consumption in Q-4 of 2006, but would have a negative 0.2 percent impact on GDP in the euro zone in the first half 2007, and would increase euro zone inflation by 0.3 percent. That said, economic growth surveys indicated significant job creation in the euro zone and a rebound in the construction sector in Germany. INSEE based its forecast on a decrease in oil prices to 60 dollars per barrel and a euro equal to 1.31 USD in the first half of 2007.

15. Lower growth in exports would be offset by dynamic household consumption. INSEE forecast household consumption to increase 2.8 percent (annualized) in Q-1 and Q-2 2007 thanks to an increase in purchasing power due to lower oil prices and a decrease in income taxes in 2007. Companies may hesitate to invest due to an expected global economic slowdown in 2007. INSEE forecast a 2.4 percent increase (annualized) in corporate investment in Q-1 and Q-2 of 2007 after a 4.2 percent increase in 2006.

Moderate Growth Sends the Unemployment Rate Down

16. GDP growth should create 115,000 jobs (including 73,000 in the private sector) in the first half of 2007, sending the unemployment rate down to a 23-year low of 8.2 percent by the end of June 2007, from 8.8 percent in October. Dubois explained that a 1.5 percent GDP growth rate would be sufficient to stabilize unemployment due to retirement of the generations born after the Second World War. Thus, a 2.0 percent growth should help reduce the unemployment rate.

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Risks in the INSEE Forecast

17. On the one hand, the increase in VAT in Germany might be offset by a decrease in the savings rate, resulting in a positive effect on French exports. And consumption in France could be higher than expected if the French adjust immediately to income tax cuts in early 2007. On the other hand, the real estate market in the U.S. could take a harder tumble than expected. And any further decline in the dollar would affect French exports outside the euro zone. INSEE did not provide an estimate of the impact of these risks on GDP growth.

Government Urges more Coordination for the Euro

18. Due to growing concerns about falling exports, Prime Minister de Villepin urged more coordination between the European Central Bank and euro zone finance ministers, reiterating on December 11 previous calls for clarification of the respective roles of the ECB and eurozone governments in exchange rate policy. His urging, promptly echoed by presidential candidates Segolene Royal and Interior Minister Nicolas Sarkozy, met with little support within the euro zone. Many French economists blame falling exports on the inability of French exporters to take advantage of the strong global economy in 2006, rather than on the strength of the euro.

Comment:

19. Q-4 GDP growth looks like a "technical" correction to the unexpected Q-3 stagnation, and should allow the government to reach its 2006 GDP growth target. A decrease in the unemployment rate to 8.2 percent by June 2007 looks possible even with moderate 2.0 percent economic growth in 2007. Clearly such results would play into the hands of the current government during the election end-game next spring.

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